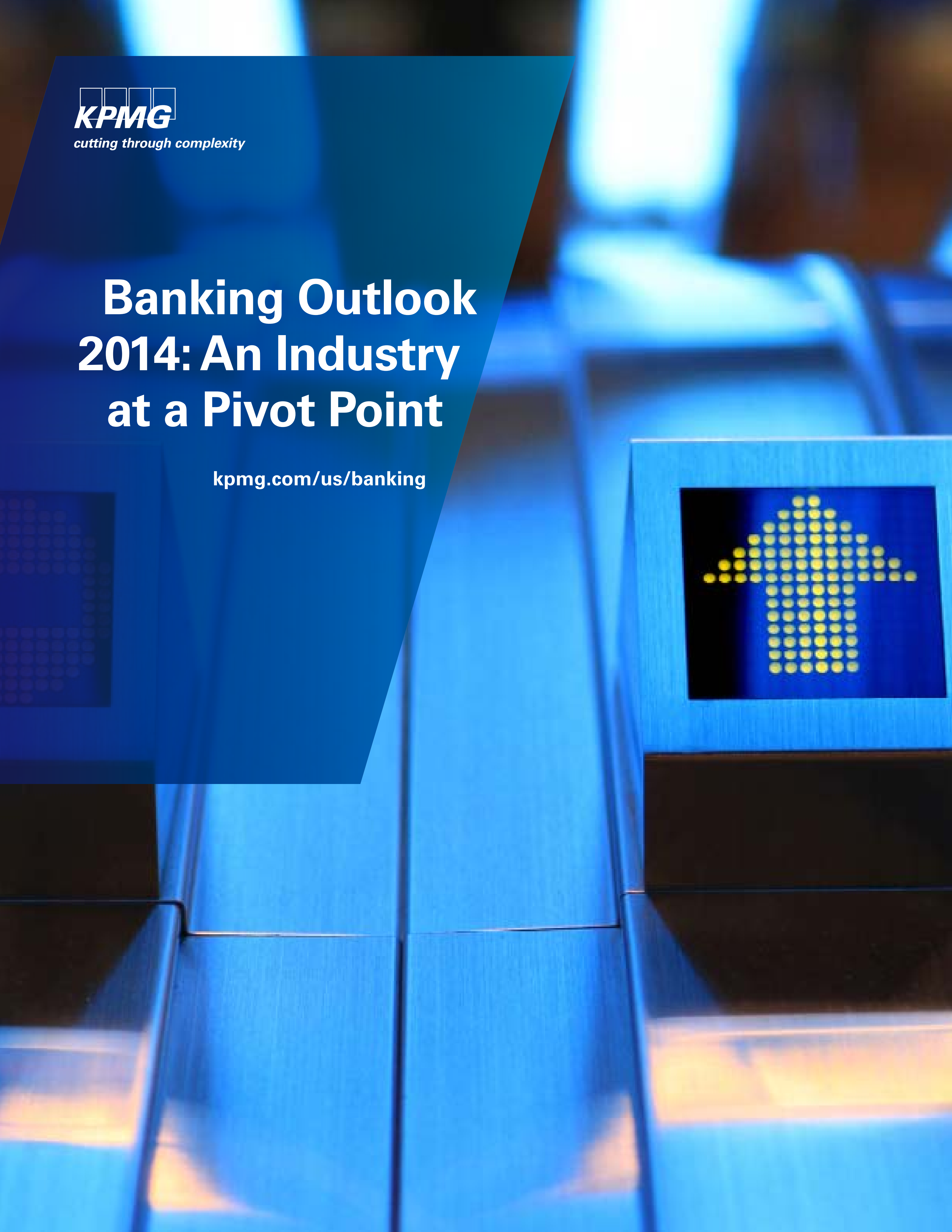

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Banking Outlook 2014: An Industry at a Pivot Point

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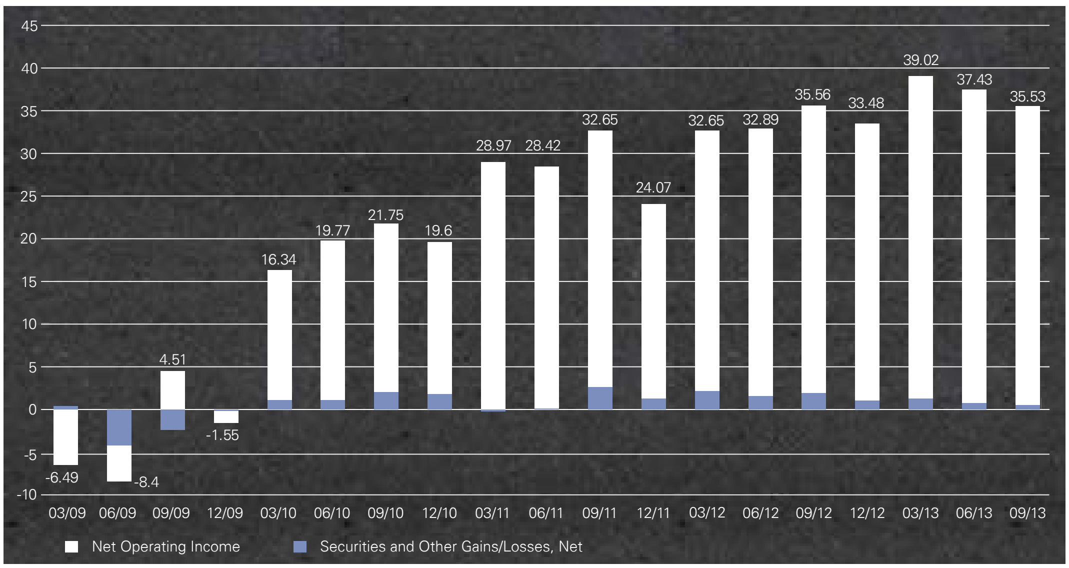
The Banking Industry is at a Crossroads

As unlikely as it may seem for an industry that has posted a 70 percent gain in net income since 2009—and strong growth in return on equity—banks face a major dilemma as they head into 2014. There is no question the industry has rebounded from the abyss of 2009, when, on the heels of a crippling credit crisis, bank failures were surging, balance sheets were bloated with bad loans, and industry return on equity (ROE) stood at a negative 3.7 percent. Since then, banks have slashed payrolls, shed noncore businesses, and written off trillions[1] of dollars in bad assets.

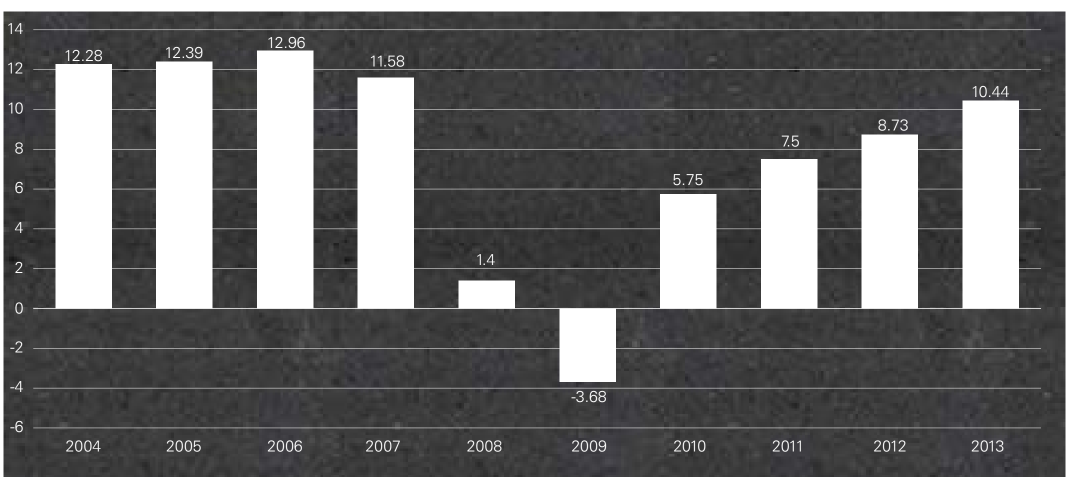
Quarterly Income 2009–2013 ($B)



Source: Federal Deposit Insurance Corp., December, 2013.

Industry ROE has moved higher than 10 percent for the first time since 2007.

U.S. Banks' ROE (%)

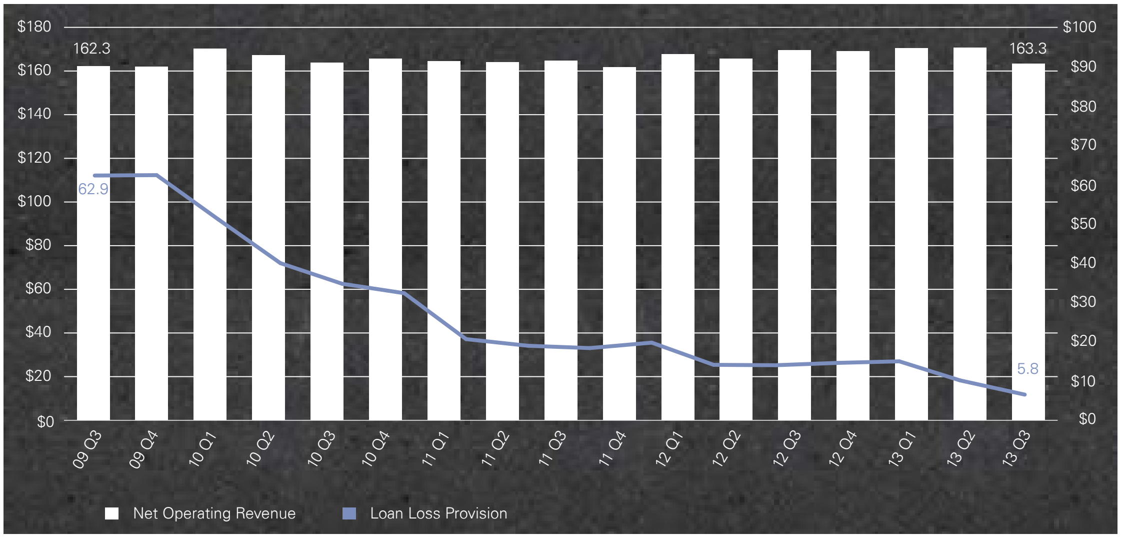


Source: Federal Deposit Insurance Corp., December, 2013.

1 "I.M.F. Puts Bank Losses from Global Financial Crisis at $4.1 Trillion," by Mark Landler, The New York Times, 4/21/09

Still, the earnings improvements of the past several years have been attributable in large part to rapidly declining expenses for loan losses and aggressive cost cutting. Now, while problem loans continue to decline, the impact of shrinking loan-loss reserves on the bottom line is diminishing—and, given the trend we see now in the credit cycle, the issue could be exacerbated as lending ticks upward gradually, possibly leading to higher credit losses. More aggressive lending, fueled by competition among banks, could tempt some banks to lower credit standards, potentially leading to higher credit costs, and even more scrutiny from regulators concerned about deteriorating underwriting standards.

Flat Revenue; Steep Decline in Loan-loss Provision



Source: Federal Deposit Insurance Corp., December, 2013.

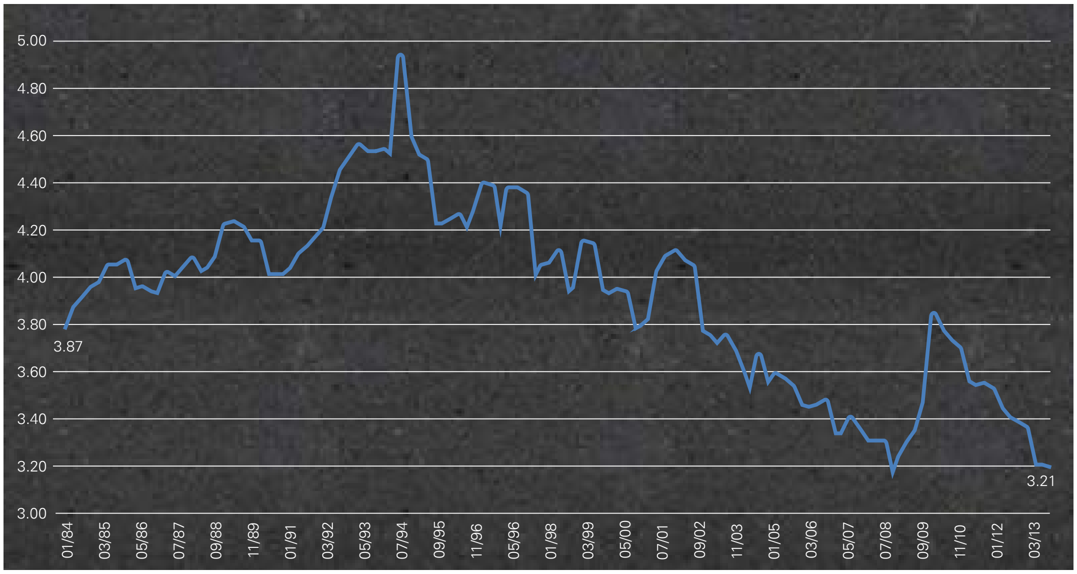
And therein lies the rub. Because for all they have been able to accomplish throughout this four-year recovery—scrubbing and bolstering balance sheets, adapting to new regulatory regimes, cutting costs—one thing banks have not been able to do, collectively, is grow their top line.

And so we have reached a pivot point—a crossroads at which hundreds and perhaps thousands of the country's banks must—in addition to their current focus on cost reductions and continued process improvement—include in their business strategy a major focus on selling products and services.

This raises legitimate questions for investors and other stakeholders, who eventually may chafe at funneling money into an industry where returns in the third quarter of 2013 amounted to 0.99 percent of assets, down from 1.06 percent in the third quarter of 2012 and 1.36 percent in the same period in 2003.[2] High on their list of questions is this: Can the banking industry actually succeed in building its top line at a time when many of the macroeconomic, regulatory, and geopolitical trends that have been pressuring revenues for the past four years are poised to extend into 2014 and beyond?

Although the forecast for the U.S. economy is for continued growth, it is for growth only slightly above the roughly two percent rate averaged over the past three years.[3] That sluggish pace suggests the Federal Reserve will continue to keep short-term interest rates low at least through 2014—and even beyond, putting continued pressure on banks' net interest margins.

Net Interest Margin 1984–2013 (%)



Source: Federal Reserve Bank of St. Louis, used with permission.

Prospects for political reforms that might help the economy—prudent measures to reduce the nation's long-term debt, an overhaul of the tax code, a sensible alternative to the next round of sequestration spending cuts in the federal budget—are constrained by the prospect ongoing for political stalemate in Washington, DC., auguring poorly for the sort of "grand bargain" the business community has been seeking. Though near the end of 2013, there was some movement toward political compromise on budget considerations that could help economic growth, serious concerns remain that the politics of the past several years could get in the way of real economic progress that is needed in the months, and possibly years, ahead.

Meanwhile, the costs and time stresses created by the regulatory environment are not going away, and will continue to affect four areas for banks: strategy and business models, interactions with customers and client assets, data and reporting structures, and governance and risk capabilities. Still, banks that continue to concentrate first on regulatory issues will be focused on solving yesterday's problems. Those that are ahead of the curve are already looking to the next challenges.

Encouragingly, the industry has demonstrated resiliency in dealing with past crises, and leading banks have already begun many of the transformations necessary to compete in the current postcrisis environment. The question this time around, when a digital economy is driving lightning-quick change and consumers have become accustomed to new, faster, and more mobile ways of doing business, is how fast the industry can change this time. Banks that embrace change and systematically transform themselves to meet new customer demands will achieve a competitive advantage in the marketplace. Those that continue to ponder—or worse yet, resist—change will suffer.

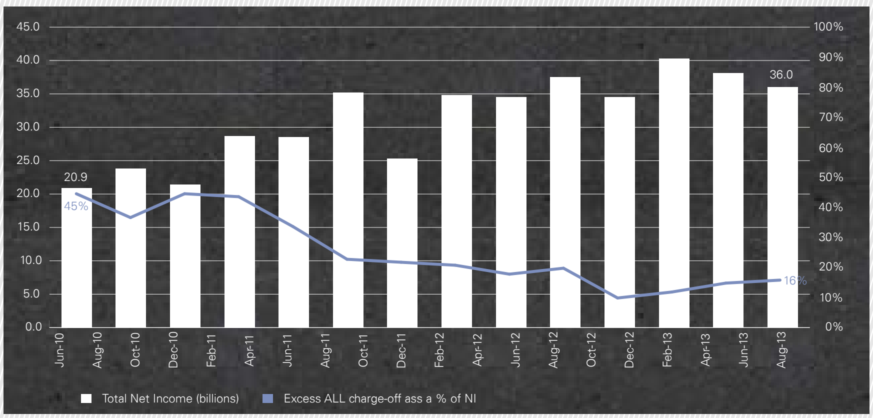
[2] FDIC: "Quarterly Banking Profile, Third Quarter 2013."

[3] "Fourth Quarter 2013 Survey of Professional Forecasters," 11/25/13 – http://www.philadelphiafed.org/research-and-data/real-time-center/survey-of-professional-forecasters/2013/survq413.cfm

What's at stake

It isn't only bankers who are dependent on the long-term health of the banking industry. So too are businesses, consumers, and politicians. A strong U.S. banking system creates jobs, links business organizations, nurtures and promotes technology transfer, builds human capital, and underpins the creation of our country's infrastructure. It is a critical catalyst for generating government tax revenues. Without sound and active banks, the creation of products and services that benefit consumers and businesses would be nearly impossible. In short, any hope of a sustained recovery by the U.S. economy depends in no small part on banks getting their houses in order. Do all that, and the industry will earn its just rewards. The industry will find a more vibrant market for its products and services, boosting its revenues. An industry in order also will buttress the argument for a less volatile and convoluted regulatory environment than the one it faces now. At the moment, the environment of uncertainty has hamstrung the industry's long-term planning capabilities.

Contribution of ALL Reversal to Net Income



Source: SNL Financial; KPMG Research

To expand on the credit point we raised earlier, our analysis suggests that reversing loan loss reserves, or allowances for loan losses (ALL), contributed to approximately 40 percent of net income in 2010 and 2011 and more recently, as ALL balances have declined, to roughly 20 percent of net income. In estimating these amounts, we viewed charge-offs in excess of loan loss provisions as effectively reversing the ALL provision. We believe charge-offs in excess of provisions (with no tax effecting) represents a simple and reasonable way to estimate the contribution to banks' net income of ALL reversals.

In the second quarter of 2010, for instance, excess charge-offs totaled $9.3 billion, or roughly 45 percent of total net income. A comparable level of contribution continued through the second quarter of 2011. Over those five consecutive quarters, ALL releases averaged 41 percent of net income.

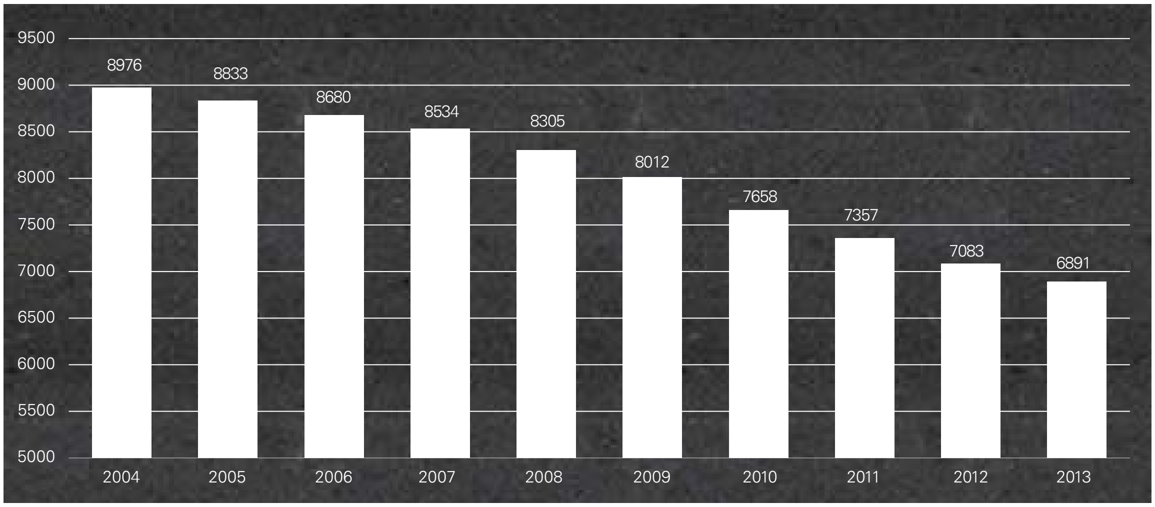
As nonperforming loans and ALL balances declined, however, the magnitude of the ALL releases declined as well. From the third quarter of 2011 to second quarter 2012, ALL releases dropped to $6.8 billion, or approximately 21 percent of net income. This tapering trend has continued to date, as ALL reversals from third quarter 2012 to third quarter 2013 averaged $5.5 billion, contributing approximately 15 percent of net income.

The impact of ALL releases will continue to wane as a contributor to net income as ALL balances decline and banks' loan portfolios either stop contracting or begin to grow. Total ALL balances measured $263 billion in the first quarter 2010 and totaled $143 billion at the end of the third quarter 2013, a decline of 46 percent. Also, as lending ticks gradually upward, banks' exposure to credit risks will increase likely causing provisions in excess of charge-offs.

The impact of this reduced ALL releases as a contributor to net can be seen in results: FDIC-insured institutions saw their year-over-year earnings fall by $1.5 billion or 3.9 percent in the third quarter of 2013, the first quarterly downturn since the second quarter of 2009.[4] Increasingly, banking industry earnings will now be determined not by cyclically low loan loss provisions, but the ability to grow revenues.

[4] FDIC: "Quarterly Banking Profile, Third Quarter 2013."

FDIC-Insured Institutions 2004–2013



Source: Federal Deposit Insurance Corp., Quarterly Banking Profile, December, 2013.

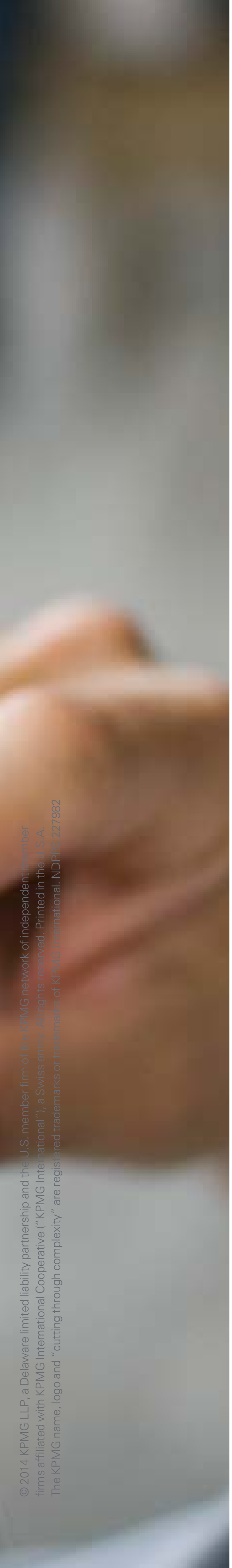
The pivot: Defense to offense

History is replete with companies that failed to pivot when circumstances required it, including, just in the past decade, numerous companies that were slow to embrace digital technologies: photo film makers who didn't appreciate the appeal of digital photography, home video distributors that resisted streaming, music businesses that relied on CD and vinyl record sales, and book distributors that stuck too long with bricks-and-mortar strategies.

As banks pivot from defense to offense, they will have to move from what has essentially become survival mode—coping with the fallout from the credit crisis and complying with new regulations—to relentlessly focusing on change that drives top-line growth. Among other strategies, this shift will require that banks:

- **Find new ways to connect with customers,** leveraging information technology to better understand what customers want and how banks can deliver it.
- **Improve their abilities to effectively manage and leverage data, including their analytics** and predictive modeling capabilities.
- **Industrialize their internal processes** to reduce complexity, risk, and cost while enhancing customer service.
- **Step up use of cloud and other emerging technology** to contain costs and accelerate the pace at which they can effect change.
- **Reexamine merger and acquisition opportunities,** not only to grow their businesses and squeeze further efficiencies from operations but also to achieve the critical mass needed to undertake the transformative changes required of them.
- **Rebuild their reputations** in the aftermath of a financial crisis that many still blame on the financial services industry, so that they can better compete for customers in an industry built on a foundation of trust.

Let's look more closely at some of the forces we expect will shape the industry in 2014.



In our view, few mandates are more important to the banking industry right now than a relentless attention to connecting with customers as a means of building new revenue streams. Banks must begin to act less traditionally and follow the path forged by other customer-centric organizations that allow themselves to be shaped by customer demand, using more mobile, more two-way, more "right-now" experiences to give customers what they want when they want it. Examples are around virtually every corner, especially in the online marketplace, where savvy merchants know what their customers buy and when they buy it, and use that information to pitch other goods and services that may interest them.

Connecting with Customers

In the banking industry, connecting consistently with customers will require that banks understand the demographics of their markets, including the characteristics that define their best customers, and knowing which products and services they are willing to pay for. It also means developing the right distribution channels, as consumers increasingly use more than one channel.

One recent study found that consumers handle four top banking activities—bill paying, viewing balances and transactions, viewing statements, and transferring money—more frequently on the Web than any other channel.[5] Additionally, the exceptional value propositions of banking are becoming increasingly unclear, as consumers also can find banking services in many more nontraditional venues now, too, including mom-and-pop, check-cashing storefronts and major retailers.

For some banks, the drive to connect with new customers may lead to providing services they haven't seriously considered in the past, for customers they haven't previously courted—including the 34 million Americans who are unbanked or underbanked.[6] How big are the opportunities? The direct-deposit-advance, or payday-loan, market is estimated at $23.1 billion. The peer-to-peer payments market is estimated at $17.1 billion. Both are served today primarily by nonbank institutions.[7] True, federal regulators have cautioned banks not to operate direct deposit advance businesses in ways that could increase their credit, compliance, legal, and reputation risks.[8]

But that doesn't mean smart banks can't find a way to compete responsibly in this space. Check-cashing, bill-paying, prepaid debit cards, and international money transfers are other services America's unbanked and underbanked have demonstrated they are willing to pay for. Banks must demonstrate that they are willing to provide those services without abusing the customer, or risk forfeiting that business to the other companies stepping in to fill the void. The FDIC has actually been encouraging banks on this front, urging them to address the unbanked and underbanked with expanded offerings of low-cost checking and savings deposit accounts, transaction services, and small-dollar loans.[9] The challenge isn't miniscule—costs for servicing such clients have, in the past, often exceeded the revenues they generate—but the opportunity is too big to ignore.

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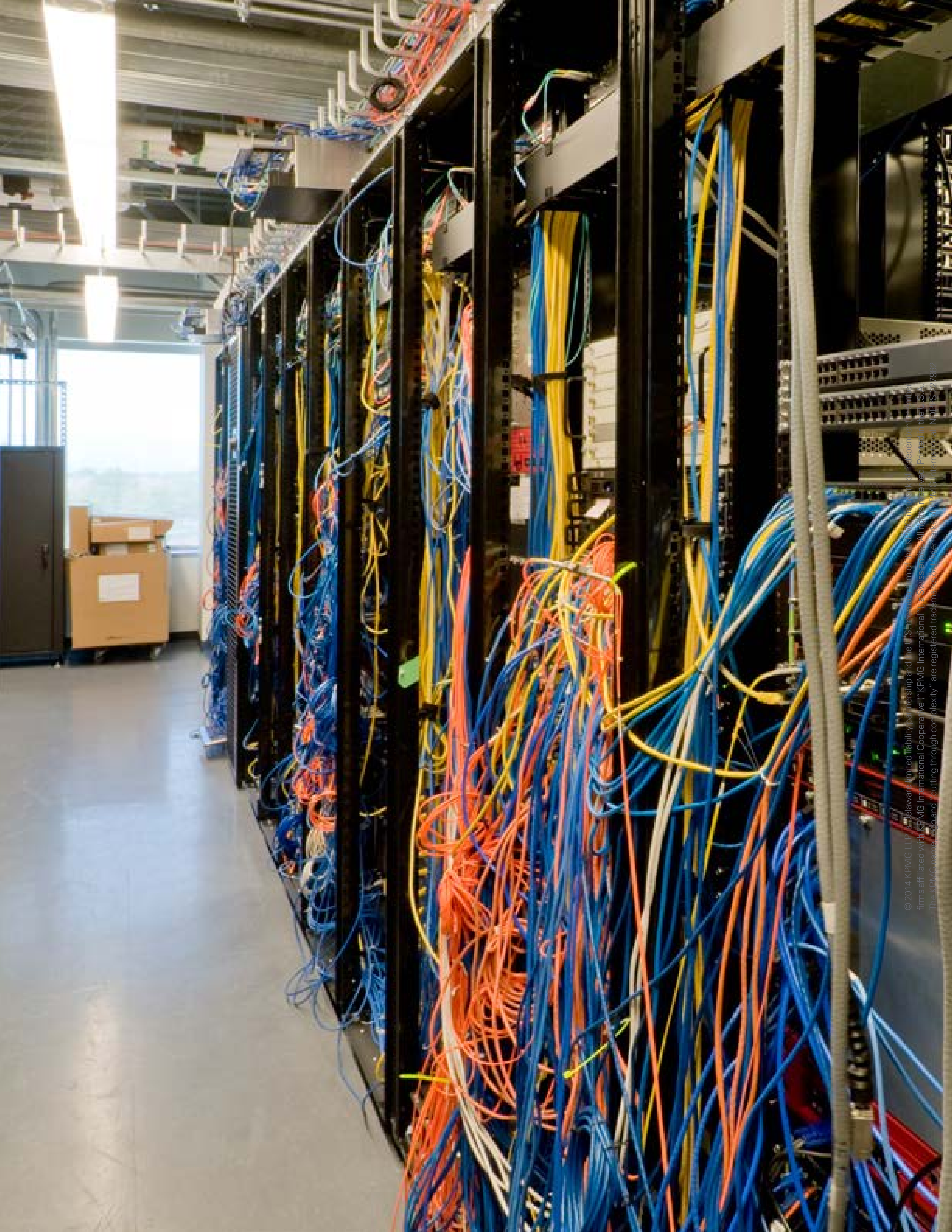
5 "The State of North American Digital and Multichannel Banking 2013," by Tiffani Montez, Forrester Research Inc., 4/2/13

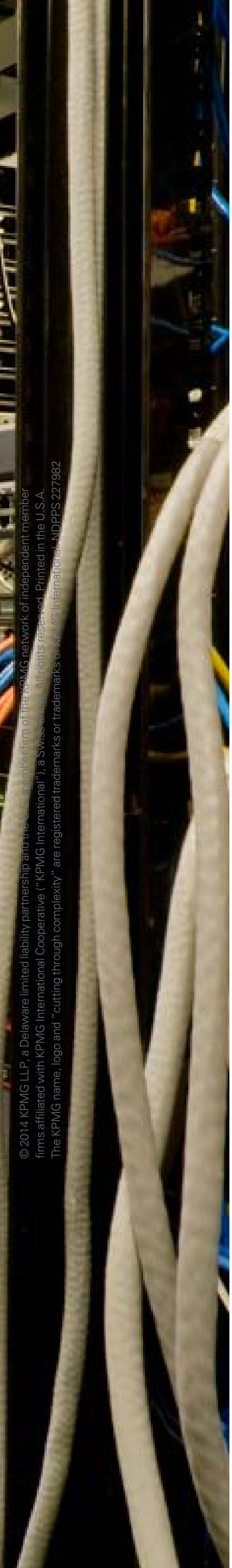
6 FDIC: 2011 FDIC National Survey of Unbanked and Underbanked Households – http://www.fdic.gov/householdsurvey/

7 Aite Group "The Debanked: A US $1 Billion Prepaid Debit Card Opportunity," Aite Group, February, 2012

8 FDIC, Proposed Guidance on Deposit Advance Products – http://www.fdic.gov/news/news/press/2013/pr13031a.pdf

9 "Walmart vs. Big Banks: The Battle for Poor Customers," by Halah Touryalai, Forbes, 12/14/12





It is a common business mistake: fixate on yesterday's crisis at the expense of preparing for the next. For the banking industry, the last crisis was one of capital and liquidity. It has consumed management's attention for four years now, and most banks have met its challenges—if only because regulators have forced them to do so.

Information Technology (IT) Transformation

In our view, the next crisis could revolve around IT, given the value and volume of data that banks generate, the attraction of that data to cyber thieves and vandals, the complexity of banks' IT systems, and banks' utter reliance on those systems, some of which are highly coordinated while others are dispiritingly disjointed.

All this will put a heightened burden on IT in the years ahead, when it must play a central role in allowing banks to pivot from defense to offense. IT must provide the information needed to determine which services and products will actually boost ROE. It must enable efforts to connect with customers, both retail and commercial. It will form the backbone of new products and services. It must help drive the efficiencies that still elude many banks. And, of course, it must continue to meet regulatory demands and defend against cyber security breaches.

None of this will happen if banks don't approach IT the right way, and don't move past the notion that using technology to attract and retain customers is an IT job. It is, unquestionably, a top-of-the-house strategic imperative, and everything about these changes in technology must be driven by the customer and the business imperatives.

Historically, banks' IT strategies have been driven by internal demands (what business units and executive leadership needed to run the business) and by regulatory imperatives (what banks had to do to comply with state, federal, and global regulations). Banks must continue responding to these needs. But as they shift their focus to revenue generation, they also must embrace IT strategies driven by customer needs, relying heavily on social media and other vast sources of data to find out what those needs are. Banks may want to take their cue from retailers, who have a history of mining customer data profitably.

Banks that are able to find the right information from the oceans of data available to them, that leverage the required hardware and software to deliver the right products and services without breaking their budgets, and that put in place the right people and processes to construct their control environment, will realize the most value from their IT systems.

To do all those things, banks will need to rethink their approach in four distinct areas:

- **Core platform transformation.** The scope of regulation is straining the technology platforms on which banks operate, and will continue to do so in the years ahead. This is being driven by many factors, including the requirements imposed by changing regulation, such as the data aggregation and reporting capabilities required by early 2016 under recent guidance from the Basel Committee. More than a few banks will find that making patches to existing IT systems will not work in trying to meet regulatory mandates, never mind the demands of a more aggressive approach to building and supporting new revenue-generating products and services. For them, an enterprise-wide upgrade to their core systems may be warranted. Many banks are also likely to rethink which systems should be outsourced, cosourced, and shifted to managed-service options.

- **Risk modeling.** Despite the considerable work done on risk models in the wake of the credit crisis, banks must continue to refine them. Regulators have been uniformly skeptical of the work done so far. In 2012, the Federal Reserve criticized some of the nation's largest banks for the quality of their stress-test submissions,[10] and in 2013, the chair of the Financial Stability Board said the risk models banks use to calculate their capital needs were still showing "worryingly large differences."[11] While these comments were aimed at the industry's largest banks, and while one can legitimately argue the merits of current risk-based standards, the need for better risk modeling is disputed by few and relevant across the banking sector. There have been a number of notable and widely reported reminders in recent months that some banks have work to do to master their risk controls.

  This isn't entirely a technology issue, either. During the housing bubble, for example, some banks had a better appreciation than others for how poorly loan originations were being handled because they sent employees into the field to check on them.[12] Banks must invest not only in improving their risk models, but also in the abilities of their people to use them.

- **Analytical tools.** According to a recent Gartner Group survey, chief information officers estimate that their organizations realize only 43 percent of technology's business potential.[13] That speaks to an enormous opportunity to do better, but only when banks have the ability to make sense of the data their IT systems are generating. Some are turning to technology here, too. In a recent interview with American Banker, for example, analytics software executive Jim Goodnight observed that leading banks are taking advantage of high-performance computing systems to engage in high-performance analytics, running, for example, as many 100,000 market-risk simulations in a matter of 15 to 20 minutes rather than the 15 to 16 hours it might have taken in the past. On the retail side of the business, the emphasis in analytics must be on using customer intelligence to drive revenues. This also requires a change in mind-set, with efforts focusing on discovering relationships and correlations in large amounts of data rather than determining their causes—moving from the "how" and "why" to the "what".

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[10] "Fed Said to Criticize Banks on Risk Models in Stress Test," by Craig Torres, Dakin Campbell and Dawn Kopecki, Bloomberg, 5/1/12 – http://www.bloomberg.com/news/2012-05-01/fed-said-to-criticize-banks-on-risk-models-in-stress-test.html

[11] "Carney Calls for Bank Risk-Model Clampdown to Repair Trust," by Jim Brundsden, Bloomberg, 9/6/13 – http://www.bloomberg.com/news/2013-09-05/fsb-s-carney-calls-for-bank-risk-model-clampdown-to-repair-trust.html

[12] "The Trouble with Banks' Risk Models: Q&A with the Chief of SAS," by Penny Crosman, American Banker, 3/28/13

[13] "Hunting and Harvesting in a Digital World: The 2013 CIO Agenda," Gartner Group – http://www.gartner.com/technology/cio/cioagenda.jsp

[14] "Three Top Cybersecurity Risks for Banks," by Victoria Finkle, American Banker, 9/23/13 – http://www.americanbanker.com/issues/178_184/three-top-cybersecurity-risks-for-banks-1062339-1.html

[15] "Three Top Cybersecurity Risks for Banks," by Victoria Finkle, American Banker, 9/23/13 – http://www.americanbanker.com/issues/178_184/three-top-cybersecurity-risks-for-banks-1062339-1.html

- **Cyber security.** Owing to the high value of their data, banks will always be a high-value target for cyber criminals. Technological advances continue to push the cost of cyber attacks down, which means banks must increase the resources they allocate to defending against them. Adrienne Haden, an assistant director of banking supervision and regulation for the Federal Reserve Board, notes that the cyber threat landscape has expanded to include not just fraud but espionage, disruption of operations, and destruction of information.[14] Cyber security will become an even broader responsibility in the years ahead as banks, eager to expand their offerings and boost efficiency, partner with third-party vendors and service providers whose networks are connected in turn to other banks, subcontractors, and third parties—all boosting the risk that an attack on one could morph into an attack on many. New technologies in mobile and cloud computing also are upping the ante. Banks will need to respond to these spreading threats on multiple fronts, building sound and secure IT infrastructures, to be sure, but also vetting and monitoring vendors and other service providers for their own compliance with security protocols. Human resources will need to be involved, too, performing background checks on new hires and providing employees with ongoing training in the safeguarding of digital information.[15] Failure to maintain a robust cyber security profile could cripple efforts to connect with customers and grow revenues.

An ocean of water, but not a drop to drink. That image of a lost-at-sea sailor is an extreme, but not wholly unfair, analogy for banks, which have oceans of data about their customers but shockingly few insights into what to do with it. Of course, banks use data to manage risk, but as they pivot from risk-mitigating defense to revenue-generating offense, banks must make better use of data to understand their customers and provide to them the products and services they want via the channels they want to use. Yes, most banks already use customer data from time to time to decide which products to market to which buyers—products like checking accounts, investment products, credit cards, mortgage refinancings, and home equity loans. But far too infrequently are they using customer data to create truly new products or services that leverage the information banks have on file about their customers, either individually or collectively.

Improve Data Analytics

Partly this is a problem of history; banks are accustomed to viewing data as a cost center; something to be saved, but seldom used. Partly it is a problem of priorities; especially over the past several years, much of the analysis banks have engaged in has been targeted at meeting risk-management imperatives. But it is partly a problem of capabilities also. With so much customer information available—in the bank's own records (credit and debit card data, demand deposit data, loan data), in credit reports, from social media, and from an array of resources that seem to be growing exponentially—banks have simply struggled with where to begin. As one of our colleagues recently wrote, faced with big data, banks need big knowledge and big perspective. They need the clarity that comes from an organizational capability to leverage data in many forms, from many places, through many methods and for a variety of purposes.[16] Yet in one of KPMG LLP's (KPMG) recent surveys,[17] only a third of respondents said their banks had a high degree of data and analytic literacy. Not surprisingly, they also said they need to get better if they want to make progress on growing revenues.

Indeed. But front-line analysts won't be able to pull this off on their own. For banks to make real progress in data analytics, executive leadership will have to make it a priority, champion its benefits, and, most importantly, allocate the necessary resources. To drive best results, executive leaders should make sure their teams hew to these principles:

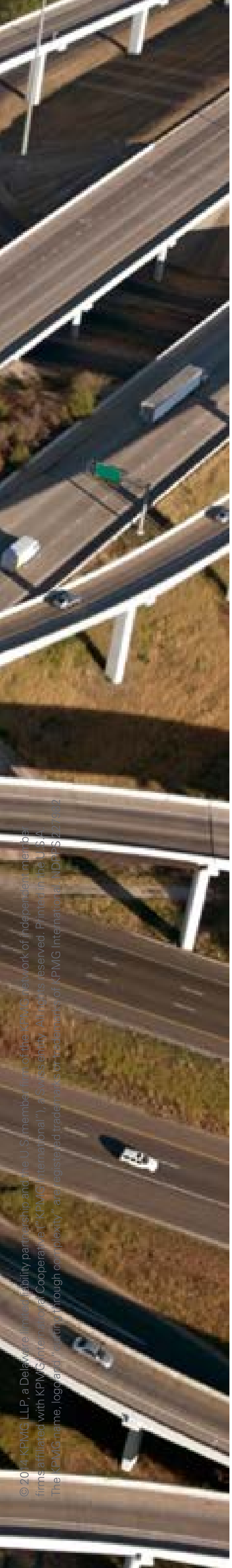
- Focus on business outcomes and critical goals, and then determine the information needed to achieve them.
- Locate, access, and improve data quality so that it can be trusted and useful.
- Develop systems and capabilities that aggregate data across business lines to create a single view of the customer.[18]
- Overcome internal obstacles by managing, measuring, and compensating employees, at least in part, on how well they use data to make decisions and drive business outcomes.

Banks that develop an infrastructure allowing them to analyze data quickly, that staff up to do that work, and that make revenue-oriented analytics part of their culture, are the banks most likely to grow their top lines.

16 "Big Data + Big Analytics = Big Opportunity," by Jeanne E. Johnson, KPMG, in *Financial Executive* magazine, July/Aug 2012.

17 KPMG 2013 Banking Outlook Survey

18 "The Trouble with Banks' Risk Models: Q&A with the Chief of SAS," by Penny Crossman, American Banker magazine, 3/28/13



Business strategies in the banking industry are of necessity multifaceted affairs right now: continue to meet ever-growing regulatory demands, continue to cut and contain costs, continue to manage through a low interest-rate environment, and with the other hand, so to speak, boost revenues by developing new products, services and delivery channels, and by connecting more deeply with new and existing customers. Technology can help shoulder the load, but unless banks "industrialize" their processes—simplify, standardize and consolidate—to reduce complexity, lesser errors, and break down the walls that separate one part of the bank from another—they'll have a hard time executing on these strategies.

Industrialize Internal Processes

Organizations that are able to industrialize their processes are typically less rigid and more flexible than their competitors, and so are better able to develop and market differentiated products appealing to a wider range of customers. They can more easily scale up, or down, in response to market trends and client needs. Among several of the examples outside the banking industry, a major automobile manufacturer embarked on this path more than a decade ago when it announced in 2002 what it called a "revitalization" effort aimed at standardizing and simplifying its technologies. The multiyear undertaking included upgrades to Ford's systems and processes, which reduced the company's dependence on vertically aligned operations and moved it toward a more flexible operating model that could focus on a differentiated product portfolio. That initiative has been credited, along with the company's well-documented, balance-sheet overhaul, with helping Ford weather the last financial crisis better than most of its peers.

Industrializing processes isn't easy; however, process change is every bit as challenging as installing a new IT system. Banks must first identify best-practice processes and adapt them to their own circumstances, then overcome employees' natural resistance to change. Success depends to a large degree on instilling a culture of change, one that is demonstrably supported by the executive team, from middle management straight through to the C-suite.

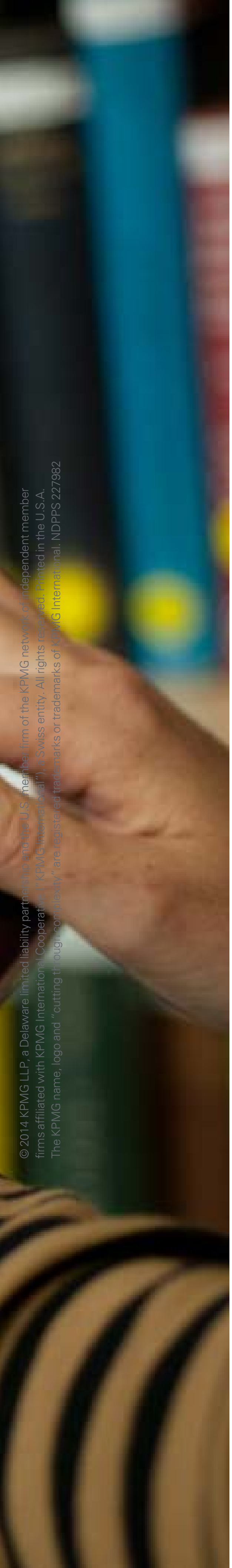
Fortunately, the payoffs can be large and wide-ranging, including reduced costs, improved customer service, and faster transaction processing. And with less time required for transactional activities, bank personnel can spend more time on the high-value work that drives revenue growth.

Other than the CFO's office, few parts of the organization have a broader or deeper view of a bank's operations and financial resources than internal audit. To limit that function to its historical role of helping the board discharge its governance responsibilities is to forego potentially lucrative insights into not only how the bank is operating but also how it might operate better and more profitably.

Leverage and Empower Internal Audit

One of the keys to understanding how banks can deliver the products and services customers want is to understand the associated risks. This is where internal audit excels. We are not suggesting that internal audit supplant the business and product development initiatives banks already support. What we are suggesting is that executive leadership makes sure there is some mechanism in place by which internal audit can periodically share with business leaders any findings and insights they might have developed in the course of their duties—insights that could help the bank improve what it is doing for its customers today, and perhaps develop new products or services for tomorrow. As part of that process, internal audit can provide reviews of operational and financial performance, make recommendations for more effective and efficient use of resources, and assess progress toward corporate goals.

Importantly, internal audit can bring special qualities to this endeavor that no other function in the organization can offer. Steeped in a tradition of independence, it can present findings that have not been watered down or filtered by others.



As banks look to build new revenue sources via new product, service and channel offerings, they will incur costs for new hardware and software—and will almost certainly need to boost staff. An obvious option for mitigating hardware and software costs is to take advantage of cloud computing.

Increase Use of the Cloud

Many banks remain attached to their legacy IT environments and still harbor basic concerns about cloud security, trust, safety, and privacy. But efficient organizations are becoming increasingly confident in their use of cloud technology, both to avoid the high cost of hardware that is often underutilized over time, and to speed time-to-market for new products and services. They recognize that cloud vendors who were once relatively secretive about their operations have become much more open about the types of controls they maintain and the reports they can provide, making it easier for banks to become comfortable with the technology. And they see that cloud vendors employ vastly more people dedicated to data security than they do, suggesting that data in the cloud could actually be more, not less, secure than data held internally. TheInfoPro, a service of 451 Research, projects that the worldwide cloud computing market will grow at a 36 percent compound annual growth rate through 2016, to a total market size of $19.5 billion.[19]

While cloud computing is becoming more common and trusted, banks must still approach the cloud carefully. Among the issues they must consider:

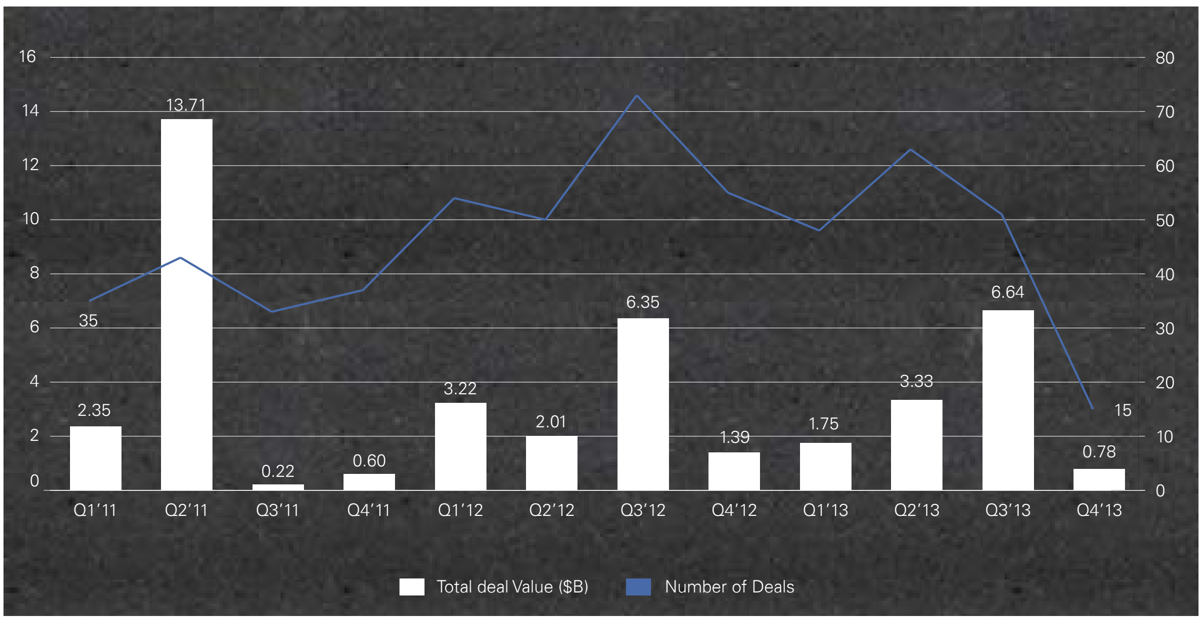
- **Data strategy and internal controls.** Banks taking advantage of cloud computing must develop a robust data strategy that allows them to evaluate cloud service providers empirically. Understanding how much internal control the bank has over its data will help it make intelligent, business-driven decisions about which data and business functions can shift to the cloud.
- **Data sovereignty.** Users of cloud computing may not always know where their data is being housed, or under whose jurisdiction it may fall. There are no global standards governing data sovereignty or residency, and many countries in the EU and Southeast Asia have rules not only around the privacy of that data but also around how that data can or cannot be moved from country to country. Banks must work with cloud service providers to make sure sovereignty issues and risks are addressed in their service contracts.

[19] "Predicting Enterprise Cloud Computing Growth," by Louis Columbus, Forbes, 9/4/13 – http://www.forbes.com/sites/louiscolumbus/2013/09/04/predicting-enterprise-cloud-computing-growth/

The mergers and acquisitions "wave" that was widely expected to rush through the banking industry over the past several years amounted to something more like a ripple. There were 162 bank mergers in the United States through the first nine months of 2013, up from 111 in the first three quarters of 2011.

Reexamine M&A Opportunities

Number of Bank Deals and Deal Values Since 2003



Source SNL Financial, excludes FDIC–assisted transactions. Used with permission

Still, mergers, joint ventures, and strategic acquisitions remain a powerful tool for growth and are likely to increase in 2014. Why? All the old reasons still exist, including the burdensome cost of regulatory reform on smaller institutions and the dearth of organic growth opportunities. But now, finally, the gap between what sellers think their institutions should command in the marketplace and what buyers are actually willing to pay appears to be shrinking, and moving into closer alignment with reality. While some sellers continue to hold out for prices in the range of two to 2.5 times book value,[20] some recent unassisted transactions were completed at closer to 1.5 times book value.[21]

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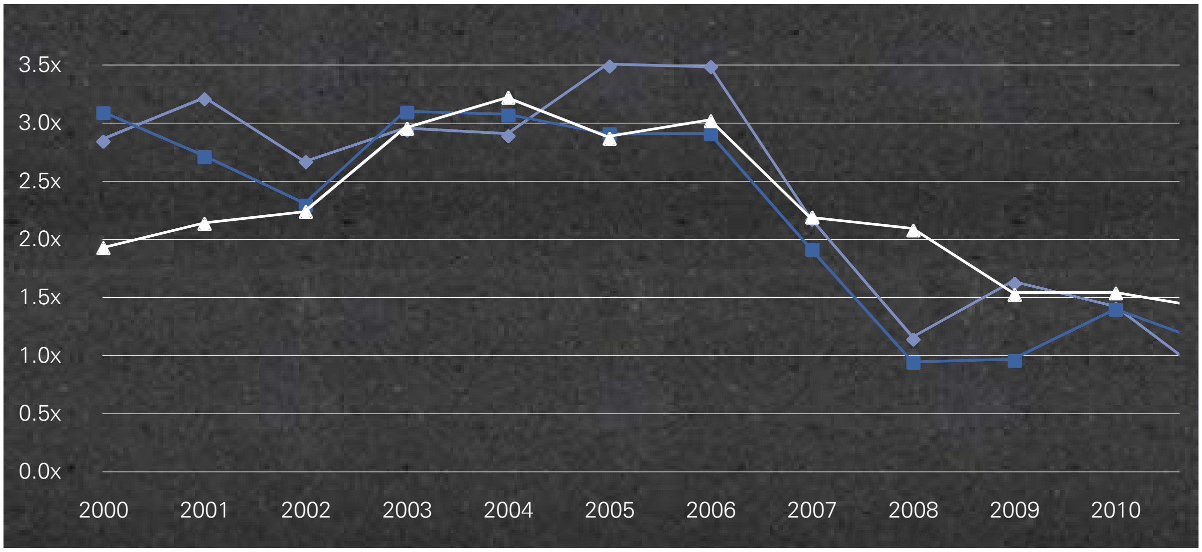
[20] "Banks Must Lower Expectations to Jump-Start M&A," by Neil Hartman and Ken Siegman, American Banker, 6/27/13 – http://www.americanbanker.com/bankthink/banks-must-lower-expectations-to-jump-start-m-and-a-1060209-1.html

[21] "Banks Must Lower Expectations to Jump-Start M&A," by Neil Hartman and Ken Siegman, American Banker, 6/27/13 – http://www.americanbanker.com/bankthink/banks-must-lower-expectations-to-jump-start-m-and-a-1060209-1.html

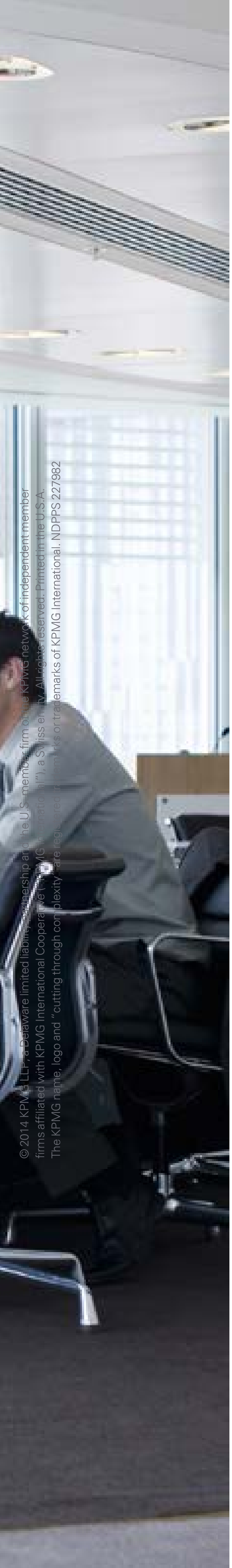
Price to Tangible Book Multiples Over Time



Source SNL Financial. Used with permission

Banks looking to pivot their focus to growth cannot ignore the opportunities presented in the M&A market—opportunities that can not only expand their market share and geographic footprint, but also, thanks to cost-saving synergies, free more resources for finding new sources of revenue. Rigorous due diligence remains important, of course. Among other things, banks will want to make sure they understand any regulatory issues that could stall or block a transaction. They also will want to ascertain the extent of any toxic assets buried on balance sheets, the level of sophistication (or lack thereof) of a target's IT systems, and the extent of any accounting issues that might create a problem for the acquirer. And they will want to look for any cultural-fit issues between themselves and their proposed partners.

> “Generally P/B multiples still well below precrisis levels (1.0x – 1.5x today vs. 2.0x – 3.0x precrises)”



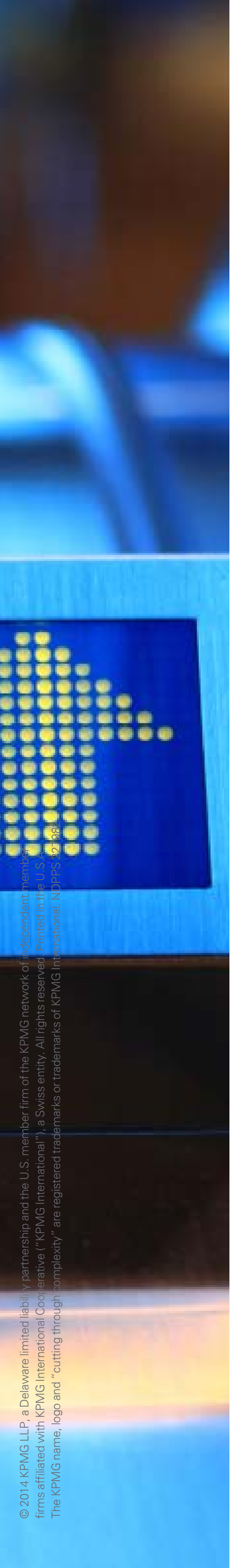
Looking at matters from a glass-half-full perspective, when it comes to reputation, the financial services industry has quite a bit of upside potential. According to the 2013 Edelman Global Trust Barometer, banks and financial institutions are still the least trusted players in the global economy.[22] That presents a challenge to banks that want to grow their revenues by connecting with customers, given that their business depends at its very foundation on the customer's trust—trust that they will get their money back, trust that they will not be swindled or overcharged, trust that their financial institutions will not be hobbled by fraud or poorly managed risks. It's also a challenge given that this reputational shortfall comes at a time when there are so many potential nonbank competitors looming on the horizon, from small and large retailers to tech companies, crowd sourcing vendors and social media sites, and when technology is making it ever easier for customers to switch providers.

Rebuild Reputation

So this, too, is another reason banks need to move in a new direction, to rethink their culture and the way they reach out to current and prospective customers, and to bear down even harder on risk controls so they can avoid the sort of headline developments that have drawn the public's attention and ire over the past several years.

Doing that will require understanding how those headline events happened in the first place, and putting in place processes and procedures to prevent them from happening again. It will require communicating the bank's strategy for treating customers and clients fairly and respectfully, and then communicating that message again—and again and again—via traditional and social media. It also may require spending more on developing value-added products and services that delight clients and make them want to reward their bank with repeat business.

[22] http://www.edelman.com/insights/intellectual-property/trust-2013/about-trust/ and http://www.edelman.com/trust-downloads/press-release/



Getting Going

The U.S. banking industry can no longer cut its way to profit growth. After half a decade focused on managing risk, cutting costs, and meeting regulatory requirements, the industry must pivot to a strategy centered on growing revenues. With its reputation badly damaged by the last financial crisis, it will require a new and unrelenting focus on connecting with customers and regaining their trust. It will require developing new products and services that appeal to customers, and are available via the channels they want to use.

Ambitious banks will find ways to cater not only to their core customer base, but to the tens of millions of unbanked and underbanked who are rapidly being co-opted by alternative providers of banking services. In all cases, it will require that banks rethink their systems and processes to be more agile and to make their analytical capabilities more insightful. Some institutions may find that the only way to meet these imperatives will be through mergers, acquisitions, or joint ventures. No matter the course, the way forward will not be easy, requiring nothing less, for many banks, than a wholesale cultural change. Yet, the alternative will be even less palatable—a gradual slide into irrelevance, an opportunity missed. The time to begin the transformation is now.

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